DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 01-0349
Gross Income Tax
Penalty
For the Years 1996, 1997, 1998

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ISSUES

I. Gross Income Tax- Application to out of state franchisor

Authority: IC § 6-2.1-1-2; IC § 6-2.1-2-2; 45 IAC 1-1-30; 45 IAC 1-1-48.

Taxpayer protests the Department's assessment of gross income tax on royalties and fees received from a franchisee operating its trademark restaurants in the state of Indiana.

II. Penalty- Request for waiver

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the Department's imposition of the 10% negligence penalty, requesting a waiver for reasonable cause.

STATEMENT OF FACTS

Taxpayer, a corporation incorporated and domiciled outside of Indiana, granted franchises to operators of its restaurants in Indiana. In May of 1997, taxpayer sold its remaining company owned restaurants to an unrelated corporation that also happened to be taxpayer's largest franchisee. Taxpayer currently functions as a franchisor. During the audit period, and pursuant to the license agreement between taxpayer and its franchisee, taxpayer owned trademarks, service marks and trade names used in the development, organization, and operation of its restaurants which feature a unique style of food. Taxpayer has established a high degree of consumer goodwill and public acceptance of its trademark, name, system of restaurants and products, over a long period of time. Franchisees, including the unrelated corporation involved in the transactions at issue in this protest, have to conform to taxpayer's manual regarding purchasing supplies, including specifying vendors, and preparing food and beverages for sale and consumption. Taxpayer retained the right of inspection of any premises and operations, the right of first refusal in the event franchisee wished to sell, and directed insurance matters. Taxpayer was also a named insured on all policies. Taxpayer filed withholding tax returns for the periods at issue indicating that it used Indiana employees.

When a franchisee entered into a franchise agreement with taxpayer, the franchisee received the right and privilege to use taxpayer's trademarks, service marks, trade names, consumer goodwill and public acceptance in the operation of one of taxpayer's restaurants. Taxpayer received fees from the franchisee for the use of such rights and privileges. Further facts will be added as necessary.

I. Gross Income Tax- Application to out of state franchisor

DISCUSSION

In general, IC § 6-2.1-1-2(a) defines gross income as "all the gross receipts a taxpayer receives" from various sources. Subsections (1), (3), (4), and (10) are most pertinent to taxpayer's arguments in this protest. Subsection (10) is the generic catchall provision covering items not delineated in previous subsections. Therefore, "gross income means all the gross receipts a taxpayer receives from any other source not specifically described in" subsections (1) through (9). Subsection (1) describes gross receipts "from trades, business, or commerce." Subsection (3) describes gross receipts "from the sale, transfer, or exchange of property, real or personal, tangible or intangible." Subsection (4) describes gross receipts "from the performance of contracts." Any one of these subsections justifies imposing Indiana's gross income tax on taxpayer's gross receipts from its activities in Indiana.

IC § 6-2.1-2-2 imposes the tax "upon the receipt of (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." Generally speaking, whatever one chooses to call the "gross receipts" taxpayer receives—royalties, management, contract, licensing, or franchise fees—by any name, they are taxable as gross income received by taxpayer. *See*, 45 IAC 1-1-30 and 45 IAC 1-1-48. (repealed, 12-30-98). The latter regulation provides in relevant part:

> A franchise system involves a particular kind of business activity carried on by a franchisee in accordance with the terms of a contract with a franchisor. The contract generally provides for the franchisor's grant to the franchisee of the use of an exclusive brand name, patent, process, territory, advertising or other right for which the franchisee pays under a schedule of fixed or variable fees or a combination thereof. The taxability of such fees and other income of the franchisor for gross income tax purposes depends upon the business relationship of the parties, where they are incorporated and doing business, and the terms of the franchise agreement.

The regulation goes on to discuss four different franchise situations. Number four is directly on point:

> Out of state franchisor with Indiana franchisees: the franchisor is taxable upon that part of his fees and income derived from activities in this state, including the operation of an in-state situs, the rental of real and personal property in Indiana, and the performance of services for in-state

> franchisees, more than a minimal or incidental amount of which takes place in the state.

Taxpayer argues its licensing a third party (a corporation that is incorporated and domiciled outside of Indiana) to operate taxpayer's Indiana restaurants, and the signing of the Agreement (which took place in another state), trumps all evidence of its connections to Indiana.

The granting of the license is not, contrary to taxpayer's argument, the sole defining parameter of its business relations with its Licensees. The granting of a license, wherever that takes pace, is a nullity if the licensor and licensee do not take some positive action in accordance with, and pursuant to, the directions and mandates set forth in the license agreement. If the parties did not so act, no restaurants are built, no food is sold, and no money is earned to be passed up the chain from restaurant to licensee to licensor. The granting of a power is an inchoate possibility, an intangible, and merely exists until such a time as it is acted upon.

The License Agreement itself outlines taxpayer's retained rights: to review licensee's sales reports, specify approved vendors, inspect the premises of the restaurants. Taxpayer also retained the right of first refusal when a licensee or restaurant wished to sell. Taxpayer also provided insurance and was the named "certificate holder" on the policy and is listed as an "Additional Insured/Loss Payee." The Agreement is replete with a plethora of evidence of taxpayer's continual control of its restaurant operations. Licensee must "conform" to taxpayer's control of the menu, i.e., the "manner of preparing and serving the Licensed Products," the food under taxpayer's brand name. Licensee must maintain "uniform and high standards of quality, service, appearance" in all the restaurants. This "maintenance" is "necessary in order to maintain [taxpayer's] public image and widespread consumer acceptance." Everything is within taxpayer's "sole judgment and discretion" regarding suppliers and vendors, plates, napkins, cups, etc. With respect to marketing and advertising, taxpayer has numerous commandments licensee must follow; marketing is essential "to the furtherance of the goodwill and public image of [taxpayer]." With respect to trademark standards, licensee "acknowledges that [taxpayer] is the sole owner of the Trademarks and all goodwill relating thereto;" they are the "sole and exclusive property of [taxpayer's]." Licensee does not acquire any "right, title, interest or claim of ownership in the Trademarks." Licensee's use of Trademarks, any and all goodwill and benefits shall inure solely to the benefit of [taxpayer] and shall be deemed to be the sole property of [taxpayer]."

The transactions here at issue—the receipt of franchise fees from taxpayer's Indiana franchisees—are inextricably related to taxpayer's activities within the state. The receipt of the franchise fees is an amount determined by and directly related to taxpayer's purposeful Indiana activities. It cannot be said that the transactions occurred entirely where the license agreements were signed because, absent the Indiana "connection" and the taxpayer's Indiana activity, the franchise agreements become abstract paper agreements of no value to the taxpayer and of no interest to the Indiana taxing authorities. In addition, the substantial portion of the activities performed in exchange for the franchise fees take place in Indiana.

What taxpayer sells, and what the franchisee purchases, is the right to vigorously exploit the intangible asset within the state of Indiana. Taxpayer's Indiana source income results from the utilization of the intangible within the state of Indiana made possible by the taxpayer's decision to establish a physical presence within the state of Indiana. Taxpayer's income is not derived from entering into theoretical paper franchise agreements created, performed, and executed where the license agreements were signed. Taxpayer's income derives from and is directly linked to its decision to purposely avail itself of an Indiana business opportunity, a decision to recruit and license an unrelated franchisee to operate its trademark restaurants, and the decision by Indiana citizens to patronize those Indiana restaurants. Taxpayer's ability to derive income from its Indiana activities is made possible by the protections, benefits, and opportunities provided by the state of Indiana. Indiana has made it possible for taxpayer to enter into this state and to obtain income from its franchise agreements. Indiana, in turn, is entitled to tax that portion of taxpayer's income attributable to this state.

FINDING

Taxpayer's protest concerning the taxability of royalties received from its franchisee/licensee operating trademark restaurants in Indiana is denied.

II. Penalty-Request for waiver

DISCUSSION

Taxpayer protests the imposition of the 10% negligence penalty on the entire assessment. Taxpayer argues that it had reasonable cause for failing to pay the appropriate amount of tax due. Taxpayer stated in its brief that there was no intent to defraud the state, and that its failure to pay the proper amount of tax was due to its interpretation of Indiana's statutes, regulations, and case law.

Indiana Code Section 6-8.1-10-2.1(d) states that if a taxpayer subject to the negligence penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit taxes held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. Indiana Administrative Code, Title 45, Rule 15, section 11-2 defines negligence as the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by Indiana's tax statutes and administrative regulations.

In order for the Department to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying or failing to carry out a duty giving rise to the penalty imposed. . . ." In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits.

Taxpayer has not set forth a basis whereby the Department could conclude taxpayer exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Taxpayer has not provided sufficient evidence to show that its interpretation of the relevant statutes and regulations is valid and reasonable. Therefore, given the totality of all the circumstances, waiver of the penalty on the entire assessment is inappropriate in this particular instance.

FINDING

Taxpayer's protest concerning the proposed assessment of the 10% negligence penalty is denied.

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